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Corporate tax evasion with agency costs

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Abstract

This paper examines corporate tax evasion in the context of the contractual relationship between the shareholders of a firm and a tax manager who possesses private information regarding the extent of legally permissible reductions in taxable income, and who may also undertake illegal tax evasion. Using a costly state falsification framework, we characterize formally the optimal incentive compensation contract for the tax manager and, in particular, how the form of that contract changes in response to alternative enforcement policies imposed by the taxing authority. The optimal contract may adjust to offset, at least partially, the effect of sanctions against illegal evasion, and we find a new and policy-relevant non-equivalence result: penalties imposed on the tax manager are more effective in reducing evasion than are those imposed on shareholders.

JEL classification: H25; H26; D82
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1. Introduction

Recent high-profile cases of corporate accounting fraud and tax evasion have generated substantial changes in the rules governing corporate governance and accounting, and in the process spawned an extensive debate regarding changes in tax rules and the enforcement

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of existing tax law.[1] In the accounting sphere, the Sarbanes–Oxley bill passed on July 31, 2002 established a regulatory board appointed by the SEC to oversee the accounting industry, created new legal standards for prosecuting corporate wrongdoing, required top management to certify their firms' financial statements and internal controls, set forth long prison sentences for executives convicted of fraud, and gave new protections to corporate whistle blowers.[2] In addition, corporate tax noncompliance is by no means a trivial issue. In 1998, a year in which (federal) corporate tax receipts were US$204.2 billion, the Internal Revenue Service (IRS) has estimated that corporate underreporting was US$37.5 billion.[3] Recently, an IRS contractor estimated the tax revenue loss from abusive tax shelters in 1999 to be between US$14.5 to US$18.4 billion, which is 50% higher than the level for 1993.[4] In spite of these recent policy developments and the apparent increases in corporate tax evasion, there is little theoretical guidance as to the impact of alternative penalty structures, or the appropriate structure of penalties, for either accounting misconduct or tax evasion.

This paper examines corporate tax evasion in the context of the contractual relationship between the shareholders of a firm and the chief financial officer (CFO), who determines the firm's deductions from taxable corporate income. The CFO is assumed to possess private information regarding the extent of legally permissible reductions in taxable income, and may also inflate the size of the firm's tax shield through illegal evasion. The incentives of the CFO to engage in tax evasion are affected by the nature of her compensation arrangement. Using a costly state falsification framework, we characterize formally the optimal (informationally constrained) incentive compensation contract for the CFO and, in particular, how the form of that contract changes in response to alternative enforcement policies imposed by the taxing authority. We find that penalties imposed on the CFO directly are more effective in reducing evasion than are those imposed on shareholders, and that the optimal contract may adjust to offset, at least partially, the incentives generated by increased sanctions against illegal evasion.

A key difficulty in achieving a solid theoretical understanding of the determinants of corporate tax evasion is the flexible contractual relationship that affects the behavior of the corporate managers. In a corporation, the shareholders, or the Board of Directors acting on the shareholders' behalf, will structure the compensation packages of managers to provide incentives for them to act in the interest of shareholders. Consider, for example, the compensation contract for the officer in charge of corporate taxes. It is in the shareholders' interest for the tax director to reduce the company's effective tax burden, net of any costs of doing so, which would include any expected penalties incurred due to detected tax

[1] Throughout the paper, we use the term "evasion" to refer to corporate tax reporting behavior that would, if discovered, be subject to civil or criminal sanctions.

[2] In the tax area, the Internal Revenue Service announced in 2002 that it will reallocate more enforcement resources toward wealthy taxpayers suspected of hiding income from their businesses, partnerships, and investments.

[3] Underreporting is only one of the three components of the total tax gap, the other two being nonfiling and underpayment. There is no estimate for corporate nonfiling, and underpayment is a quite different issue.

[4] US General Accounting Office (2003, p. 13). The GAO (2003, p.1) defines abusive shelters to be "very complicated transactions promoted to corporations and wealthy individuals to exploit tax loopholes and provide large, unintended tax benefits."